United States Court of Appeals

for the Second Circuit

APPELLANT’S REPLY BRIEF

ORIGINAL **75-7100**

To be argued by
MILTON S. ZEIBERG

United States Court of Appeals
FOR THE SECOND CIRCUIT

B

PLS

WILLIAM H. NOLAN, on behalf of himself and all others similarly situated,

Plaintiff-Appellant,

v.

RICHARD B. MEYER, CARL ANTENUCCI, STEVE NARKER, THOMAS WHITE, LESLIE C. KISSICK and MICHAEL N. SOTTILE, as Administrators and Trustees of the Profit Sharing Plan for the Employees of Merrill Lynch, Pierce, Fenner & Smith, Incorporated,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

REPLY BRIEF OF PLAINTIFF-APPELLANT

MILTON S. ZEIBERG
Attorney for Plaintiff-Appellant
60 East 42nd Street
New York, New York
Tel: OX 7-0722

249 Press of Fremont Payne, Inc., 417 Canal St., N. Y.—966—6570

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REPLY BRIEF OF PLAINTIFF-APPELLANT

This Brief is respectfully submitted in reply to the arguments of Appellees herein. It is respectfully submitted that Appellees' arguments are not responsive to: (a) the fact that profit-sharing plans constitute substantial federal subject matter; and, (b) the jurisdiction of the federal common law claim herein.

I. Appellees have failed to overcome the jurisdictional issue herein by an unsupported assertion that profit-sharing plans are unregulated.

The argument Appellees muster to distinguish *Ivy Broadcasting Co.* v. *American Telephone & Telegraph Co., et al.*, 391 F. 2d 486 (2d Circ., 1968), on jurisdictional grounds, is baseless. The action at bar is as persuasive a case for the application of jurisdiction of a federal common law claim as *Ivy, supra.* Appellees seek to avoid the established, well-reasoned cases cited by Appellant with an unsupportable statement that ". . . all involved direct federal statutory regulation of the subject matter involved, either in the form of federal requirements or prohibitions" (Brief, p. 6). This vague conclusion is refuted by the Congress itself. The "Interim Report of the Private Welfare and Pension Plan Study, 1971", Senate Report No. 92-634 of the 92d Congress, 2d Session (cited in Appellant's Brief at p. 38) sets forth a complete description of the federal regulation affecting the subject matter.

Appellees' assertion that the Welfare and Pension Plans Disclosure Act is irrelevant to Appellant's claim because it does not regulate profit sharing plans is specious. The House Report, *supra* (Appellant's Brief, at p. 37), states that the Act was "specifically designed to exercise regulatory controls over pension and welfare funds." Moreover, the same report (Appellant's Brief, at p. 39) states, "It was expected that the knowledge thus disseminated would enable participants to police their plans."

Indeed, the House of Representatives in Report No. 93-533, the text of which is set forth in full in an Addendum to Appellant's Brief (at p. 34) is replete with descriptions of the "*regulatory responsibilities* to the federal statutes involved." (Emphasis added.)

The Internal Revenue Code, 26 U.S.C.A. § 401, *et seq.*, and the Welfare and Pension Plans Disclosure Act, 29

U.S.C.A. § 301, *et seq.*, regulate plans from inception to termination (Appellant's Brief, p. 6). Failure of compliance with the latter Act is a federal crime, 29 U.S.C.A. § 308(a).

To contend, as Appellees do, that tax incentives and reporting have nothing to do with federal regulation and restraints upon employees—who were intended by the Congress to be the primary beneficiaries of these laws—is to defy reality. Senator Javits effectively brought the point home when he testified before the House Sub-Committee on Labor (House Document 73-183, U.S. G.P.O., 1972). Senator Javits testified as follows:

> "The key fact, Mr. Chairman, and one which too often remains hidden under the self-laudatory rhetoric of self-proclaimed pension spokesmen, is that *the majority of private pension plans in this country are established and operated on the basis of three dangerously obsolete assumptions.*
>
> "The first of these assumptions is that an employee is going to work for one company all or most of his working career. *The second assumption is that the company can and should use the pension plan as a club to prevent the employee from seeking job opportunities elsewhere.* The third assumption is that the company will stay in business forever in substantially the same or expanded form as when it installed the pension plan.
>
> "It is these outmoded and unrealistic assumptions which are at the head of what is wrong with private pension plans today and which have caused so many employees to leave plans emptyhanded and utterly brokenhearted. * * *" (Emphasis added)

Congress does not pass laws idly as Appellees would wish the Court to believe. To equate the federal legislative history of profit-sharing plans with marriage as Appellees do (Brief, p. 7) is absurd. Could Appellees logically claim that marriage is created as a trust under federal legislation as are profit-sharing plans? Could Appellees logically claim that marriage requires under federal law the

annual filing with the Secretary of Labor of a 16-page questionnaire detailing under penalties of perjury yearly beginning and ending statements of assets, investments, income, fees and commissions paid to trustees, party-in-interest transactions, loans against the trust, and the number of participants as do profit-sharing plans? Could Appellees logically claim that marriage requires a surety-company bond under federal law for the benefit of beneficiaries? Of course, they cannot so do. The analogy is senseless. The realities are that there is a total absence of federal regulation of marriage whereas there is comprehensive federal regulation of profit-sharing plans.

Thus, there is no sensible basis for the Appellees' untenable argument that the application of federal common law in *Ivy* was based on a comprehensive federal regulatory scheme whereas it is inapplicable to federally-qualified profit-sharing plans because they are not regulated. Profit-sharing plans and annual reports are required to be filed with federal agencies—not state agencies. Appellees distort the irrefutable issues in contending there is no federal regulation on the subject matter before the Court.

The Appellees' argument against jurisdiction of the federal common law claim herein is erroneously based upon an untenable conclusion that there is no direct federal statutory regulation of the subject matter involved. Jurisdiction of the federal common law claim is well-founded upon the authorities referred to in Appellant's Brief.

II. Appellees have misstated their own case *Merrill Lynch* v. *Ware*. Ware does not preclude the application of federal common law.

Appellees infer (Brief, p. 12) that the Supreme Court in *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Ware*, 414 U.S. 117 (1973), specifically rejected federal common law. The Court did not do so. It upheld a state anti-trust

and labor law, because those laws did not conflict with federal policies. At 140, the Court held:

> "What has been said above provides the answer to this argument. It is in line with the principle, long established, that the National Government's power, under the Commerce Clause, to regulate commerce does not exclude all state power of regulation. Southern Pacific Co. v. Arizona, 325 U.S. 761, 766-767 (1945); Brotherhood of Locomotive Firemen & Enginemen v. Chicago R. I. & P. R. Co., 393 U.S. 129 (1968); Huron Portland Cement Co. v. Detroit, 362 U.S. 440 (1960)."

Therefore federal preemption of a subject matter does not preclude the operation of strong state public policy so long as it does not conflict with the federal policy. There is nothing in *Ware* which conflicts with the adoption of a rule of federal common law on the subject matter.

Appellees further assert (Brief, p. 12) that the Merrill Lynch argument in *Ware* was that the New York law be nationally applied. That however was *not* what Merrill Lynch really put forth in *Ware*. Their main argument in *Ware* was that the issues were subject to arbitration before the New York Stock Exchange because § 6 of the 1934 Securities Act preempted a California state non-arbitration statute. The Supreme Court rejected *those* arguments by holding at p. 136:

> "* * * Merrill Lynch has not alleged that arbitration will effect fair dealing or result in investor protection. It suggests only that investor confidence not be shaken further by public airing of employer-employee disputes. There is no explanation of why a judicial proceeding, even though public, would undermine investor confidence. It is difficult to understand why muffling a grievance in the cloakroom of arbitration would undermine confidence in the market.* * *"

An underlying argument by Merrill Lynch in *Ware* to the effect that the New York law be applied because the Exchange is located in New York City, was rejected by the Supreme Court in *Ware* in 414 U.S. at p. 137. That claim was self-contradictory to the arbitration argument, because the rule of decision at arbitration before the Exchange is "fair and equitable principles of trade" (Exchange Constitution, Article VIII and regulations thereunder)—not New York law.

What the Supreme Court did conclude in *Ware* was that federal preemption of a subject matter did *not* preclude the application of strong state public policies so long as they did not conflict with federal policies.

There is, therefore, no bar in *Ware* to federal common law on the subject of employee restraints under profit-sharing plans, nor to federal application of the reasonableness of restraint test of such restraints as held in *Bradford* v. *The New York Times,* 51 F.2d 501 (2d Circ., 1974).

III. Appellees misstate the jurisdiction issue herein in citing Beam, Cuff and Haley, cases which founded jurisdiction directly on a federal statute. The jurisdiction claim herein is based directly on federal common law.

Appellees summarize their argument against jurisdiction on the grounds that no federal statute creates a right of action, and therefore there is no federal question jurisdiction (Brief, pp. 7, 12). From the untenable argument that profit-sharing plans lack federal regulation, Appellees then argue that the federal statutes cited did not create federal question jurisdiction and therefore the Congressional concern of the subject matter covered by these statutes "surely cannot be said to have done so" (Brief, p. 7). That proposition was soundly refuted in *Ivy, supra,* by this Court, and in the numerous cases in the Supreme

Court cited in Appellant's Brief, pp. 12-8. See also, Hon. J. Skelly Wright, "The Federal Courts and the Nature and Quality of State Law", Wayne Law Review, Vol. 13, No. 2 (1967). It is Appellant's submission that a federally qualified profit-sharing plan is as significant federal subject matter for the application of federal common law as a telephone bill, a free railroad pass, or a federal check. Appellees have not addressed a single argument against any of the subject matter applications of federal common law by the Supreme Court in the cases cited in Appellant's Brief, *supra,* and this silence must be taken as a tacit admission they cannot do so. All Appellees have argued is that profit-sharing plans are not federally regulated, and this contention is shown to be specious and unsupported.

To divert the issue presented—a direct claim to jurisdiction based on federal common law, Appellees cite cases which denied jurisdiction of claims founded directly on a federal statute which did not provide a civil remedy for the claim asserted. *Beam, Cuff* and *Haley,* recently decided in this Court, and cited in Appellees' Brief, founded jurisdiction directly on a federal statute which did not provide an express remedy for the relief requested. Thus, the jurisdiction issue was decided on the same grounds as in *Barlow* and *Lieberman* (Appellant's Brief, pp. 19-38). In *Beam, Cuff* and *Haley* there was no challenge to the validity of a trust provision under principles of federal common law, but an assertion that the federal courts review a trustee's decision or honesty. These cases are readily distinguished on jurisdictional grounds from *Ivy* as well as the action at bar since no claim is made here for jurisdiction or relief on the basis of a federal statute. *Moore's Federal Practice,* Vol. 1A, § 0.318[1], p. 3701, *et seq.*

IV. The facts herein clearly establish unreasonable restraint and a penalty for competitive employment. Appellees wrongfully assert that a negative covenant is requisite to restraint.

Appellees assert that since there was no negative covenant barring Appellant from competitive employment, there was no restraint. Appellees also cite a recent case decided by this Court, *USAchem Inc.* v. *Goldstein,* Nos. 74-1201, 74-1223 (February 14, 1975) Slip Op. 1817, a negative covenant case which held forfeiture of benefits constituted liquidated damages. (Appellees' Brief, pp. 8 and 15). Neither rule is applicable on the facts and law in this action.

The action at bar stems from the construction of the "employee choice" doctrine in *Bradford* v. *The New York Times, supra,* referred to in the New York case, *Kristt* v. *Whelan,* 4 App. Div. 2d 195, 164 N.Y.S. 2d 239 (1st Dep't, 1957), aff'd without opinion 5 N.Y.2d 807, 181 N.Y.S. 2d 205 (1958). In *Kristt,* the employer had amended the plan (as here) to insert a forfeiture clause for competitive employment at a time several years after the commencement of employment. *Kristt* held, *inter alia,* that the benefits were gratuities, and therefore the employer could amend the plan, and it further held that reasonableness of restraint was not an issue to be considered with respect to forfeiture for competitive employment because the employee had the choice of remaining and retaining the benefits or leaving and forfeiting them—the latter constituting the "employee choice" doctrine.

In *Bradford,* this Court stated it could not accept the theory that New York has adopted the so-called "employee choice" doctrine which is alleged to make judicial determination of reasonableness unnecessary, 501 F2d 55. The *Bradford* decision also discussed employee restraint cases

which led "* * * to the forfeiture of an amount posted by the employee * * *", 501 F2d 58. These holdings give rise to the isssues presented herein. At bar, there are no trade secrets, confidential communications, unique services, or post-employment compensation, as there were in *Bradford.* Although there was a negative covenant in *Bradford,* that decision condemned the "employee choice" doctrine in *Kristt,* and in *Kristt,* as here, there was no negative covenant.

Appellees assert (Brief, p. 8) that because there was no restrictive covenant there was no limitation on Appellant's right to seek other employment. Appellant submits that the holding in *Bradford* applied to the facts at bar establishes forfeiture for competitive employment to be unreasonable and not measured by any legitimate interest of the employer, and constitutes an unenforcible penalty.

Article 11.1 of the Plan at bar [39a] is without geographic or time limitation (notwithstanding Appellees' protestations (Appellees' Brief, p. 2) that there is only a 6-month limitation because payment is due in that time). As the clause is drawn it is a single-edged sword and must be construed against the party who drew it. Merrill Lynch maintains offices in almost every major financial center in the world. The restriction is all-encompassing in time and space. However, forfeiture of the benefits for competitive employment is not measured by any legitimate interest of Merrill Lynch, because under the law the benefits can never revert back to the employer. A prohibition contained in 26 U.S.C.A. § 401(a)(2) prevents reversion. The forfeited benefits are therefore not measured in terms of compensating the employer for the loss of the employee's services, but are solely in the nature of a penalty to the employee if he leaves and competes. The forfeiture has no relationship to the loss, and clearly exceeds the degree of protection the employer to which he is entitled to protect its legitimate interests.

Moreover, the benefits are in the nature of additional compensation to the employee under the doctrine in *Inland Steel Company* v. *N.L.R.B.*, 170 F.2d 247 (7th Cir., 1948), cert. den. 336 U.S. 960. Being the property of the employee, the forfeiture of the benefits for competitive employment is in the same nature of the "bond" in the *Dyer's* Case, Year Book, 2 Hen. 5, folio 5, pl. 26 (C.P. 1415), the landmark English common law case decided in the Fifteenth Century. In that case the employee signed a bond for the payment of a sum of money to his former employer upon condition that if he "* * * shall not use his art and craft as dyer in the town for half a year the obligation shall be null and void." When the employer brought suit, the Court held:

> "[T]he obligation is void because the condition is against the common law, and by God, if the * * * [employer] were here, he should go to prison till he paid a fine to the King."

The notion that forfeiture of deferred compensation rights does not constitute a restraint on the employee is rejected by modern courts. In *Muggill v. Reuben H. Donnelly Corp.*, 62 Cal. 2d 239, 398 P.2d 147 (1965), the deferred compensation plan provided that "payment to any retired Employee shall be suspended or terminated in the event such retired Employee at any time enters into any occupation * * * in competition with any phase of the business of * * * [the] Employer." There was no covenant by the employee not to compete—only the forfeiture in the event he did so. The court, however, recognized the obvious fact of life that an employee, faced with a penalty of this nature, is not as free to engage in a competitive business as he otherwise would be, and held that:

> "the provision forfeiting plaintiff's pension rights if he works for a competitor *restrains him from engaging in a lawful business and is therefore void.*" (398 P.2d at 147). (Emphasis Added By Court.)

Similarly, in *Estate of Schroeder* v. *Gateway Transportation Co.,* 53 Wis. 2d 59, 191 N. W. 2d 860 (1971), the court recognized that a forfeiture of this nature—even without a covenant—constitutes *"a powerful deterrent to the employee's exercise of the right to compete"* (191 N. W. 2d at 865) and held such deterrent to be an invalid restraint of trade." (Emphasis Added.)

There is a procedure in the securities industry among member firms, unique in the business world, by which a former employer is notified of the new employment of its former employee and is given an opportunity to file an objection to such employment with the New York Stock Exchange. The procedure is referred to in the industry as "clearance". The employee cannot work at his new employment until an RE-4 Form has been cleared. Upon receipt of the form, the Exchange notifies the former employer who has the right to object to the new employment for any reason. If there is an objection, the Exchange may schedule a hearing. Under the clearance procedure, if Merrill Lynch had desired to raise any objection with respect to solicitation of former customers in Appellant's new employment, it was free to do so. However, having been informed of the change of employment to another member firm and not raising any valid objection, there has been a waiver of the right to object to any aspect of the competitive employment. In the industry, there is much solicitation among member firms for registered representatives, and such cross-pollination is indigenous to that business. These industry practices are unique and are factors to be considered in evaluating the merit issues herein of competitive employment.

V. Conclusion.

Appellees' arguments against jurisdiction of the federal common law claim are unsupported on the facts and law. The judgment of the District Court should be reversed.

Dated: New York, New York, May 9, 1975.

Respectfully submitted,

Milton S. Zeiberg
Attorney for Plaintiff-Appellant
60 East 42nd Street
New York, New York

Tel: OX 7-0722

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BROWN, WOOD, FULLER,
CALDWELL & IVEY
Attorneys for Myers, et al.